

PUBLIC DISCLOSURE

April 23, 2001

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**Heritage Bank South Valley
RSSD Number 2819158
18625 Sutter Boulevard
Morgan Hill, California**

**Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, California 94105**

NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

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INSTITUTION

Institution's CRA Rating: This institution is rated Satisfactory.

Heritage Bank South Valley's lending, as measured by its loan-to-deposit ratio, is reasonable. The bank originated the substantial majority of its small business loans within its assessment area. Lending patterns exhibit good penetration of assessment area geographies, including low- and moderate-income tracts. Small-business lending to businesses with revenues of \$1 million also exhibit an adequate response to assessment area credit needs.

PERFORMANCE CONTEXT

DESCRIPTION OF INSTITUTION

Heritage Bank South Valley operates as a \$48.9 million unit bank serving the commercial-banking needs of customers located primarily in the cities of Morgan Hill and Gilroy. The bank opened on January 18, 2000 as a subsidiary of Heritage Commerce Corporation and, prior to that time, operated as a branch of its affiliate, Heritage Bank of Commerce. Its primary banking focus is developing banking relationships with small- to medium-sized businesses reporting \$1 to \$20 million in gross annual revenues. As reported on its December 31, 2000 Call Report, commercial lending and nonfarm, nonresidential real-estate secured lending accounts for 53 percent of the bank's portfolio followed by construction lending (43%). Consumer lending accounts for less than 1 percent of the bank's total loan portfolio and is primarily offered on an accommodation basis to established business-banking customers. The bank's one office is located in Morgan Hill.

Loan Type	Dollar Amount ('000s)	% of Total
Commercial and Industrial & Non-Farm/Non-Residential Real Estate	\$22,200	53%
Construction	\$18,190	43%
Secured by 1-4 Residential/Multi-Family RE	\$1,079	3%
Consumer and Credit Cards	\$405	1%
Total (Gross)	\$42,022	100%

Heritage Bank South Valley principally offers real-estate secured commercial, construction, Small Business Administration (SBA), and equipment loans. Business development efforts focus on developing loan and deposit relationships with business owners associated with Heritage Bank - South Valley board members, soliciting referrals from existing customers, and sales calls to businesses operating within specific industries. The Morgan Hill office offers the full range of the bank's loan and deposit services. Financial institutions operate 17 branch offices in the cities of Morgan Hill and Gilroy with deposits totaling \$897 million. Heritage Bank South Valley's market share of that total is 3.7 percent¹. There are no legal impediments or economic conditions preventing the bank from meeting assessment area credit needs.

DESCRIPTION OF ASSESSMENT AREA

Heritage Bank South Valley's assessment area includes the cities of Morgan Hill and Gilroy in their entirety and portions of the cities of San Jose and Llagas-Uvas, all of which are incorporated into the San Jose PMSA. As illustrated below, middle-income tracts constitute the majority of the assessment area's 12 census tracts followed by upper- and moderate-income tracts, and then by low-income tracts. Consistent with this distribution, middle-income census tracts also contain the largest population.

¹ Federal Deposit Insurance Corporation (FDIC), Summary of Deposits, Offices and Deposits of all FDIC-Insured Institutions, Santa Clara County, Cities of Morgan Hill and Gilroy, Data as of June 30, 2000.

Income Categories	Census Tracts		Population	
	Number	%	Number	%
Low Income	1	8%	7,613	9.0%
Moderate Income	2	17%	10,458	12%
Middle Income	7	58%	54,383	64%
Upper Income	2	17%	12,060	14%
Assessment Area Total	12	100%	84,514	100%

Based upon the assessment area’s median family income of \$53,267, low-income families comprise 20 percent of assessment area families, moderate-income comprise 18 percent, middle-income comprise 25 percent, and upper-income families comprise 37 percent of assessment area families. Families below the poverty level constitute 6 percent of the assessment area population.

Services constitute the assessment area’s largest industry, accounting for 41 percent of all companies followed by retail trade (18%) and manufacturing (7%). Consistent with local economies, businesses reporting revenues of \$1 million or less account for 88 percent of all assessment area businesses. Within its assessment area, the cities of Morgan Hill and Gilroy are distinct communities each with separate economies. Farming and farming-related industries such as food processing companies constitute a large portion of Gilroy’s economy, complemented by the recent development of business parks centered around independent, light manufacturing companies. In contrast, light manufacturing and warehousing companies associated with high tech industries comprise a large portion of Morgan Hill’s economy principally due its proximity to Silicon Valley companies located in San Jose and Santa Clara. Morgan Hill also serves as a suburban area, with accompanying retail business, providing housing and services for San Jose/Silicon Valley workers.

SCOPE OF EXAMINATION

Examiners evaluated Heritage Bank South Valley’s performance under the Community Reinvestment Act’s Small Bank Performance Criteria. These criteria evaluate the bank’s loan volume in comparison to its deposit base (Loan-to-Deposit Ratio), lending inside and outside the assessment area (Lending in Assessment Area), distribution of credit extended to businesses of different sizes (Lending by Business Revenue), and dispersion of lending throughout the geographies within the assessment area (Geographic Distribution of Loans). The bank’s responsiveness to consumer complaints was not evaluated because the bank received no CRA-related complaints since opening in January of 2000.

Loan products considered under the Small Bank Performance Criteria incorporated a sample of 89 small business loans totaling \$19 million originated during the period beginning January 18, 2000 through December 31, 2000. The initial assessment utilized the entire loan sample in order to evaluate the bank’s loan volume in comparison to its deposits and the volume of lending within the assessment area. Only those loans extended inside the assessment area were used to evaluate the geographic distribution of bank’s small business lending. Also, examiners

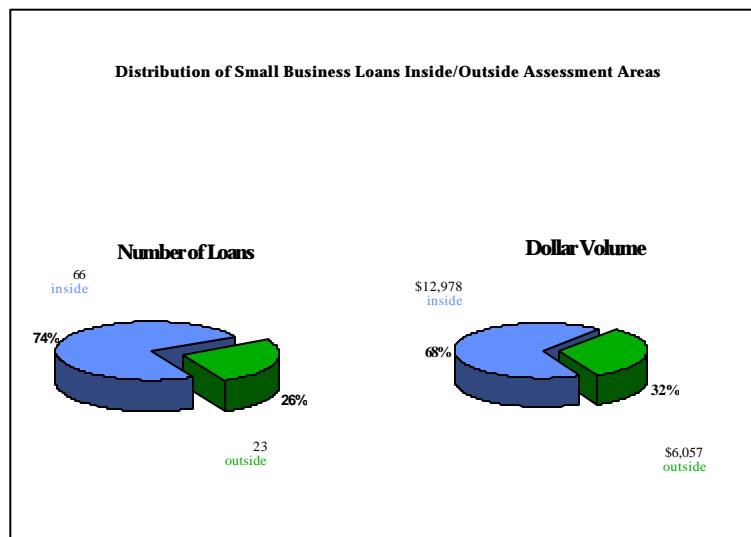
collected the revenues on a sample of small business loans (66 loans) inside the assessment area to evaluate the bank's record of lending to businesses of different sizes.

Loan-to-Deposit Ratio

Heritage Bank South Valley's lending activity, as measured by its loan-to-deposit ratio reflects a satisfactory record of meeting assessment credit needs. Since commencing operations in January 2000, the bank's loan-to-deposit ratio averaged 103 percent, ranging from 86 to 124 percent. As a start-up, Heritage Bank South Valley purchased the \$25.6 million in loans and \$13.7 million in deposits of Heritage Bank of Commerce's Morgan Hill branch. Since January 2000, Heritage Bank South Valley has originated \$16.5 million in new loans and \$27.5 million in new deposit relationships.

Lending in Assessment Area

Heritage Bank South Valley originated a majority of its small business loans within its delineated assessment area. As illustrated, the sixty-six small business loans the bank originated within its assessment area accounted for 74 percent of all of the small business loans it funded during the sample period. The dollar volume (\$12.9 million) of the small business loans within the assessment area represented 68 percent of the bank's small business loan originations and was reasonable.

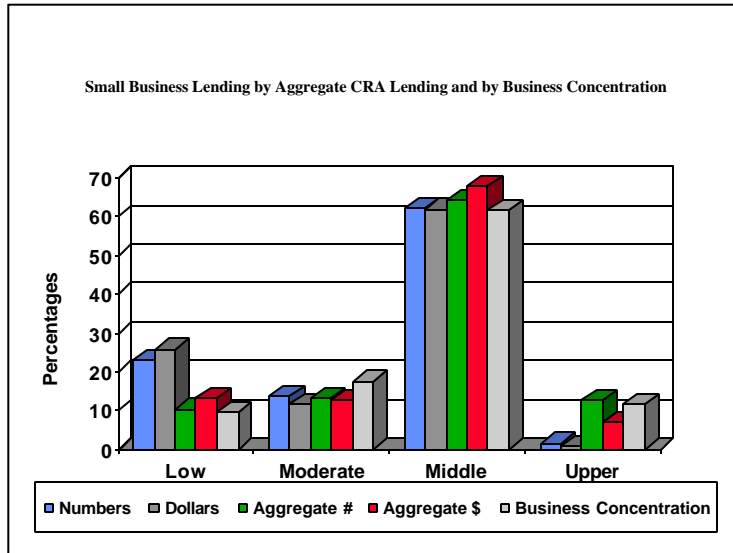


Lending by Business Revenue

Heritage Bank South Valley has demonstrated satisfactory performance in extending credit to businesses of different sizes, particularly in loan amounts of \$100,000 or less. Overall lending results indicate that the bank extended 26 (39%) of its 66 small business loans to businesses with revenues of less than \$1 million (small businesses). The corresponding dollar amount to those businesses totaled \$5.6 million or 43 percent of the \$12.9 million in small business loans originated during the review period. Heritage Bank South Valley's overall percentage of lending to small businesses was less than that of similarly situated financial institutions. However, the bank's lending in amounts of \$100,000 or less to small businesses represented 45 percent in number and 46 percent in dollar volume of total small business loans extended and exceeded similarly situated peer levels. This lending activity responded to a small business credit need articulated by members of the bank's community.

Geographic Distribution of Loans

Heritage Bank South Valley’s small business lending results reflects a good loan dispersion throughout the assessment area, including low- and moderate-income census tracts. As illustrated, the bank’s loan penetration in the assessment area’s low-income census tract exceeded the aggregate small business lending reported by financial institutions operating within the bank’s assessment area. It also exceeded the concentration of businesses within the low-income tract as reported by Dun & Bradstreet. The bank’s lending concentration in moderate- and middle-income census tracts was comparable to aggregate market lending as well as the percentage of businesses in those geographies. These lending results indicate that the bank’s delivery systems are effective, particularly with respect to activity in low- and moderate- income tracts which encompass the city of Gilroy, which is located 12 miles south of the bank.



Response to Complaints

Heritage Bank South Valley has not received any complaints relating to its CRA performance during the review period. Accordingly, the bank’s performance in responding to complaints was not considered in evaluating its CRA performance.

Compliance with Fair Lending Laws and Regulations

Heritage Bank South Valley substantially complied with fair lending laws and regulations including the Equal Credit Opportunity Act and the Fair Housing Act. The bank’s concurrent consumer compliance examination identified no violations of anti-discrimination laws and regulations. Heritage Bank South Valley maintains the necessary fair lending policies and procedures to identify violative practices and provides bank personnel with periodic fair lending training.

GLOSSARY OF FREQUENTLY USED TERMS

Area Median Income (Median Income)

The median family income for the Metropolitan Statistical Area (MSA) if a person or geography is located in an MSA, or the statewide nonmetropolitan median family income, if a person or geography is located outside an MSA.

Assessment Area

A geographic area which generally consists of one or more MSAs or one or more contiguous subdivisions, such as counties, cities or towns. Assessment areas also include geographies in which the bank has its main office, its branches and its deposit taking ATMs, as well as the surrounding geographies in which the bank has originated or purchased a substantial portion of its loans (including home mortgage loans, small business loans, small farm loans, and any other loans the bank chooses, such as those consumer loans on which the bank elects to have its performance assessed).

Community Development

- (1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals.
- (2) Community services targeted to low- or moderate-income individuals.
- (3) Activities that promote economic development by financing business or farms which have gross annual revenues of \$1 million or less or that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs.
- (4) Activities that revitalize or stabilize low- or moderate-income geographies.

Community Development Loan

A loan that has as its primary purpose community development; and, except in the case of a wholesale or limited purpose bank:

- (1) Has not been reported or collected by the bank or an affiliate for consideration in the bank's assessment as a home mortgage, small business, small farm, or consumer loan, unless it is a multifamily dwelling loan; and
- (2) Benefits the bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s).

Community Development Service	A service that has as its primary purpose community development, is related to the provision of financial services, and has not been considered in the evaluation of the bank's retail banking services under CRA.
Consumer Loans	Loans to one or more individuals for household, family or other personal expenditures. A consumer loan does not include a home mortgage, small business or small farm loan. Examples of consumer loans are: Motor Vehicle Loans, Credit Card Loans, Home-Equity Loans, Secured Consumer Loans and Unsecured Consumer Loans.
Families	Defined by the U.S. Bureau of Census as all persons occupying a housing unit related to the householder by birth, marriage or adoption. A single person living alone or two or more unrelated individuals occupying the same household are not considered to be a family.
Geographies	Census tracts or numbering area blocks delineated by the U.S. Bureau of Census in the most recent decennial census.
Households	Defined by the U.S. Bureau of Census as all persons occupying a housing unit.
HUD Adjusted Median Income	Based initially on the area median income derived from the most recent decennial census, the Department of Housing and Urban Development adjusts the figure annually for inflation.
Income Level	Includes low-income, moderate-income, middle-income and upper-income.
Low-Income	An individual income that is less than 50 percent of the HUD- adjusted median income or a census tract or block numbering area with a median family income that is less than 50% of the area median income.
Median Income	See Area Median Income and HUD Adjusted Median Income
Metropolitan Statistical Area (MSA)	An area qualifies as an MSA if it contains a city with a population of at least 50,000 or is defined by the Bureau of the Census as an urbanized area and has a population of 50,000 or more and a total metropolitan population of 100,000.

Middle-Income	An individual income that is at least 80 percent and less than 120 percent of the HUD-adjusted median income, or a census tract or block numbering area with a median family income that is at least 80 and less than 120 percent of the area median income.
Moderate-Income	An individual income that is at least 50 percent and less than 80 percent of the HUD-adjusted median income, or a census tract or block numbering area with a median family income that is at least 50 and less than 80 percent of the area median income.
Qualified Investment	A lawful investment, deposit, membership share, or grant that has as its primary purpose community development.
Real Estate Mortgage Loan	Defined by the Home Mortgage Disclosure Act (HMDA) as a home purchase loan, home improvement loan or the refinancings for both. A home purchase loan is any loan secured by and made for the purpose of purchasing a dwelling. A home improvement loan is for the purpose, in whole or part, of repairing, rehabilitating, remodeling, or improving a dwelling or the real property on which it is located and is classified by the financial institution as a home improvement loan.
Small Bank	A bank that, as of December 31 of either of the prior two calendar years, had total assets of less than \$250 million and was independent or an affiliate of a holding company that, as of December 31 of the prior two calendar years, had total banking and thrift assets of less than \$1 billion.
Small Business	Businesses with gross annual revenues of \$1 million or less as defined by the Community Reinvestment Act.
Small Business Loan	Business purpose loans with original amounts of \$1 million or less as defined by the instructions for the Consolidated Reports of Condition and Income (CALL Report) for entry on schedule RC-C, part II "Loans to Small Businesses."
Upper-Income	An individual income that is 120 percent or more of the HUD-adjusted median income, or a census tract or block numbering area with a median family income that is 120 percent or more of the area median income.